Ed Sibley: Culture, diversity and the way forward

Speech by Mr Ed Sibley, Deputy Governor (Prudential Regulation) of the Central Bank of Ireland, at the Central Bank/Trinity College Dublin School of Law conference "Culture, diversity and the way forward for corporate governance in Ireland", Dublin, 25 October 2018.

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Good afternoon ladies and gentlemen and welcome to the final session of today's conference.

This morning we heard about the process of conducting a behaviour and culture review, how that works in practice and the learnings we can gain from such a process. In the second session, our colleagues from academia shared important insights into their research and the application of these lessons for cultural change. This session will focus primarily on 'the way forward'.

In my remarks, I will cover:

- Why cultural change is important, building on Derville's earlier remarks[1];
- Diversity matters;
- Practical steps for effecting cultural change; and
- In brief, the regulatory and supervisory work of the Central Bank.

Why is Cultural Change Important?

Mark Twain is credited with saying that "History does not repeat itself but it rhymes"[2]. The effects of the history of ineffective risk cultures, poor incentives, unacceptable behaviour and short-termism are clear. Change is required to ensure that the future does not rhyme too closely with the recent past.

Trust in financial services and banking in particular has been severely damaged by the history of the financial crisis and the succession of conduct scandals that have subsequently emerged. As I have spoken about previously, this loss of trust elevates prudential risks and contributes to poor consumer outcomes[3].

The underlying causes of the financial crisis have been much covered[4] in recent months, so I will not spend time on them today. There are a myriad of examples of misconduct. The tracker mortgage scandal in Ireland is the largest and most recent local example. Further afield, we have, for example, seen manipulation of benchmark interest rates[5], fraudulently signing customers up to products en masse[6], the interim findings of the Royal Commission in Australia on Misconduct in the Banking[7], Superannuation and Financial Services Industry, and the emergence of evidence of large and small banks facilitating money laundering on a systemic scale[8].

To be clear, many of these conduct issues have resulted from rules and laws being broken. So, it is important to emphasise that a starting point for operating in a regulated environment is compliance with the rules and regulations that govern the industry. But it is also clear, that rules and regulations are not sufficient to always drive the appropriate outcomes from both a prudential and a conduct perspective. The fact that something is considered legal does not necessarily mean it is right, nor does it mean that it is fair or equitable[9].

"So, the law is just the last line of defence. Ethical behaviour is more than just complying with the letter of the law. When bankers take decisions, they must be aware that there is more to consider than just the legal and financial aspects[10]."

I would note that these types of issues are not unique to the financial services industry. There are many examples of large-scale conduct issues in many industries. For example, the behaviours of some pharmaceutical firms in relation to the opioid crisis[11]; the vehicle emissions scandal in the motor industry; or the recent super complaint covering multiple industries launched by Citizens Advice in the UK on how loyal customers pay more for essential energy, mobile, broadband and financial services[12].

It is a legitimate question to ask why such behaviour repeats itself across different geographies, times and industries. However, my responsibility only extends to the financial services industry, and what can be done to build on the extensive rules that are in place to drive better prudential and conduct outcomes. And this is why, as we have moved from a period of intensive crisis management to one of crisis prevention and enhancing resilience we have increasingly focused on culture and diversity in financial services firms.

As you have already heard today, culture is integral in driving peoples' behaviour in how they make decisions, treat consumers, assess risk and ultimately how the organisation is governed. A culture that is operating ineffectively can encourage and reinforce practices that are unsound, unsafe and threaten the stability of a firm and how its customers are treated.

Diversity Matters

In this context, diversity matters – diversity of thought, background, experience and intrinsic and extrinsic characteristics. Indeed, a lack of diversity at senior management and board level is a leading indicator of heightened behaviour and culture risks.

Similar people looking at similar information and facing similar circumstances are, unsurprisingly, likely to rely on similar assumptions and make similar decisions. This type of groupthink contributed to the depth of the financial crisis internationally and in Ireland and contributed to many of the conduct scandals that have subsequently emerged.

Low levels of diversity in key decision-making roles in banks and other financial services firms creates excessive risks and will inhibit necessary cultural change. While some firms are starting to make progress, much more needs to be done to increase the diversity of experience, thought, background and attributes at senior levels, to reduce the likelihood of groupthink, reduce overconfidence, improve decision-making, increase the level of internal challenge, improve risk management, and reduce excessive resistance to external challenge.

While gender diversity is only one aspect of diversity, it is a very important one, and one that is relatively easy to measure. It is striking that women remain seriously under-represented at senior levels across financial services.

Our previous research on diversity in financial services[13] and the assessment of diversity undertaken within the Behaviour and Culture review starkly evidences this lack of gender diversity across the entire financial system. For example, in the five years to the end of 2017, men had been appointed for more than nine out of 10 of the most senior and influential roles in the retail banks (Chairpersons, Chief Executives, Chief Finance Officers, Heads of Business Lines and so on). Many of these appointees have similar backgrounds, educations and experience.

In other words, while there is evidence of the situation beginning to change, there is an acute lack of diversity in those senior roles that are central to how banks make their decisions, set strategy, calibrate risk appetites and treat their customers. The issues identified in the banks are also evident across the rest of the financial services sector.

This is not a unique circumstance in Ireland. International Monetary Fund (IMF) research[14] has highlighted both the lack of gender diversity at senior levels in financial services and the associated macroeconomic costs. Globally, less than 2% of banks' CEOs are women, and less than 20% of banks' executive board positions are held by women.

This is not to suggest that diversity is all about gender. Diversity is a much broader concept. Different personalities (e.g. optimist versus pessimist), educational background, ethnicity, and diversity of thought can all contribute to facilitating a variety of perspectives and more effective challenge.

When the UK Financial Services Authority conducted a review into the collapse of the Royal Bank of Scotland[15], it identified significant overconfidence by board members prior to the financial crisis, and in particular in relation to the acquisition of ABN AMRO. The Dutch Central Bank[17] has also identified a tendency towards consensus (prompting people to agree with the majority opinion) and optimism (an unwarranted sense of comfort) type behaviours in organisations.

We have clearly set out our expectations of the five retail banks as part of the Behaviour and Culture review. We have told each bank to submit an outcome focused diversity strategy supported by an implementation plan by 30 November. We expect each plan, at a minimum, to include clear expectations, implementation targets and consider a range of measures of diversity.

We will also be undertaking further work in 2019, including across the wider banking and insurance sectors, to drive improvements in diversity and inclusion across the financial services sector. This is important from a crisis prevention perspective and improving the understanding, consideration and treatment of their customers.

Effecting Cultural Change

It is clear that many firms do recognise the need for cultural change. Furthermore, there is evidence of progress across the financial services sector. In this context, I welcome the creation of an Irish Banking Standards Board, which aims to promote a continuous improvement culture across the Irish banking industry. However, it is clear that a lot more needs to be done.

"If you want something new, you have to stop doing something old"[16]. In other words, successful cultural change requires an understanding of the prevailing culture.

As Derville mentioned earlier, we have seen time and time again that what happens within organisations can be at odds with their stated visions. These vision statements regularly espouse commitments to customers' needs, at a time when the organisation is failing to sufficiently consider them. A gap between the stated vision and the real action is a sign of an inauthentic message, of a mindset that is incongruous to declared beliefs and a sign that 'something new' is needed and 'something old' needs to stop.

In developing the 'something new', leaders need to adopt a mature and self-aware position in order to understand how they can strike the balance in delivering for all their stakeholders and how they message this across the organisation so it will embed in the day-to-day operations of their firm. The leaders of regulated institutions need to reflect when their behaviours are not consistent with their intentions and then consider how to put things right.

Unless there is work done to reshape the culture, the old culture can act as an anchor, slowing down and in some cases even stopping real change. Therefore, to fully implement a new strategy or to rebuild an organisation to be effective in a changing environment, it is critical to reshape culture as well.

The primary responsibility for reshaping culture rests with the executive team, under the direction of the board. It is not a human resources or organisational design exercise. It is a leadership responsibility. It requires leaders to take a long hard look at the current culture, the existing business processes, the work attitudes and behaviours *they* foster. Without first establishing what the current culture is, the issuance of lofty mission statements or long lists of core values are merely paying 'lip service' to implementing effective cultural change.

Since employees tend to take their cues on what is important and how to behave from their leaders, negative activities and behaviour at the top foster negative behaviours further down the organisation.

"A good organisational culture is about more than avoiding good people doing bad things; it is about equipping and enabling good people to do ever better things[17]." A firm in seeking to effect cultural change can take some practical steps to achieve this aim. I will suggest five as a starting point:

1. **Communicate and "walk the talk"** - the cultural values and expectations of the firm need to be consistently communicated and modelled by the top, middle and lower management levels.
2. **Enhance diversity at senior levels** – meaningfully addressing the acute lack of diversity at senior levels requires: more ambition, including in targets and measures; more than lip service being paid to diversity programmes; better building of pipelines of talent; considering the overall construct and functioning of the executive management layer when making appointments; and identifying and reducing barriers to change.
3. **Practice, process, performance** – principles and values need to be reinforced through practices and processes, including training and particularly performance management. There must be clear alignment between individual roles and objectives and wider purpose, strategy and outcomes, with people held accountable for their actions.
4. **Ongoing assessment and checking** – boards and executives need to have mechanisms and measures to understand whether the culture they espouse is consistent with the culture of the organisation, and consider how they would identify where it is not. Considering how decision-making, risk identification, product development, the use of behavioural economics, the treatment of whistleblowers and everything in between works in an organisation is key to understanding the culture of the organisation.Boards and executives need to consider the information they receive and seek (including through second and third lines of defence) to inform their view on the culture of their firm.
5. **Incentivisation** –in its broadest sense, i.e. not just financial, is fundamentally linked to behaviours; for example, ensuring promotion, recognition, and the variable compensation element of remuneration is consistent with the behaviours expected of employees will help to ensure that the culture of the firm is reinforced. This should include actively celebrating those who come forward to identify issues and behaviours that are not in line with the espoused values and desired culture of the firm.

If done well, variable pay can support and incentivise behaviours that are consistent with the values and culture espoused by boards and executives. Of course, the reverse is also obviously true. The requirement[20] for firms to have long claw back periods should, all things being equal, help to enhance aligning reward with a longer-term perspective. For example, if a significant proportion of an executive's remuneration can be demanded back over a period of several years, then that executive is likely to pay more heed to the longer-term sustainability of the business they are writing and the risks they are taking.

Regulation and Supervision

It is undoubtedly the case that the standards of governance and risk management in financial services firms have improved in the last decade. This has been driven by the strengthening of the regulatory framework and the intrusiveness of supervision. However, the pace of cultural change and lack of diversity at senior levels show that while you can put leopards in cages, they are unlikely to change their spots.

The Central Bank's work of recent years is towards the forefront of the growing international work on behaviour and culture, together with our connected work on diversity. The Bank of International Settlements, the European Central Bank; the Group of 20; the New York Federal Reserve and the Bank of England have all identified culture as an important issue."

We will continue to develop our approach in this area, building on the work of the last few years, as well as continuing to learn from international best practice. This includes, as Derville has outlined, our view that a Senior Executive Accountability Regime (SEAR) should be implemented in Ireland through legislation. In this context, I am delighted to have Richard Fox, from the UK Financial Conduct Authority, with us today to share the UK experience of its Senior Managers Regime (SMR).

In short, we will continue to focus on regulated firms' cultures and the important element of diversity as part of intensive and intrusive approach to supervision. This will continue to be underpinned by the credible threat of enforcement.

Conclusion

The Irish financial system needs to be resilient and trustworthy so that it sustainably serves the needs of the economy and its customers over the long term. Resilience has undoubtedly improved, but trust in the system has not.

Culture is not a substitute for compliance with rules, for regulation, for intrusive supervision. The starting point for operating in a regulated environment is compliance with the rules and regulations that govern the industry. Our focus on culture is not about substitution or replacement, it is about achieving better prudential and conduct outcomes – for the system and for individual consumers – than an entirely rules-based approach can deliver.

Referring back to Derville's earlier remarks, whether you believe it is a case of rooting out the bad apples or addressing the rottenness of a whole barrel, it is evident that we need greater diversity of the leaders in the financial services industry and a cultural shift in the how the industry is run.

Meaningful cultural change should prevent financial services firms from flying too close to the sun and instead, striving to be ahead of regulation and supervision in a positive way, before legislation and regulation forces them to change. Truly serving the needs of the economy and consumers over the long term not only requires learning from and addressing the sins of the past. It also requires the foresight to address the challenges of the future, creating a "system that can deepen financial inclusion, better meet the needs of ageing populations and help fund the transition to a low carbon economy."

In other words, that we think more of Daedalus and his craftmanship, than of his son, Icarus when we think of how financial services serves society's needs.

I will conclude here. I look forward to hearing from my esteemed panellists and audience members about cultural change. I will hand you over to Sylvia Cronin, Director of Insurance, who will moderate the final panel of the conference.

Thank you for your attention.

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[1] Derville Rowland, Director General, Financial Conduct, Central Bank of Ireland, Bad Apples or Bad Barrels? How effective Culture Mitigates Conduct Risk

[2] Attributed to Mark Twain (James George Eayrs attributes the quote to Mark Twain as early as 1971 in his book "Diplomacy and its discontents")

[3] See, for example: Miguel Ampudia, Spyros Palligkinis, The ECB Working Paper Series, Trust and the household- bank relationship

[4] For example, see Ed Sibley, The Banking Crisis – A Decade On

[5] For example, see www.ft.com/libor-scandal

[6] For example, see Federal Reserve Press release, Responding to widespread consumer abuses and compliance breakdowns by Wells Fargo. February 2018.

[7] See Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

[8] For example, See press release from the Danish Financial Supervisory Authority (FSA)

[9] For example, see Ed Sibley, Is it legal? A Question of Culture

[10] Danièle Nouy, Chair of the Supervisory Board, Ethics in banking – from Gordon Gekko to George Bailey, October 2018

[11] For example, see Financial times, Ending America's opioid crisis requires more than a moral crusade

[12] Citizens Advice, Excessive prices for disengaged consumers: A super-complaint to the Competition and Markets Authority

[13] Central Bank of Ireland, report on Behaviour and Culture of the Irish retail Banks, July 2018 and Central Bank of Ireland report on 'Demographic analysis -Applications for Pre-Approval Controlled Function (PCF) roles in regulated firms – 2017'

[14] House of Commons Treasury Committee, Financial Service Authority Report into the failure of RBS, October 2012

[15] De NederlandscheBank, Supervision of Behaviour and Culture, Foundations, practice and future developments, 2015

[16] *"If you want something new, you have to stop doing something old"* was first articulated by Peter Drucker

[17] Allison Cottrell, CEO of the Banking Standards Board, Transforming Culture in Financial Services, FCA Discussion Paper